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DIRECTORATE OF INTELLIGENCE

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China: Second Thoughts on Shenzhen

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Summary

In a significant about-face, reform leaders have moderated their support for the Shenzhen Special Economic Zone, once touted as the model for economic reform and the 'opening to the outside.'

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Shenzhen's poor export performance, its disappointing results in attracting high tech foreign firms, and continuing problems with corruption have drawn increasing fire from conservative critics, forcing Deng to concede that the zone has not been a success. Signs of Shenzhen's diminished stature include a freeze on state funding to the zone and postponement of measures that would have increased Shenzhen's autonomy. Beijing has also cut back on plans to develop Shenzhen-like zones in 14 coastal cities.

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We believe the downgrading of Shenzhen signals an adjustment of China's development strategy. Although foreign trade and investment will still be encouraged, the 'Shenzhen model' of granting foreign trade autonomy to selected localities will probably be curtailed in favor of renewed central control. China will probably place greater emphasis on

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the invigoration of established industrial bases, such as Shanghai, instead of building zones from scratch. New foreign investment will be scrutinized in terms of supplying needed technologies and contributing to China's export potential. Efforts may be made to curtail the booming trade in consumer goods from Hong Kong through Shenzhen, which some Chinese leaders view as counterproductive and uncontrollable. The new trade strategy will continue to provide opportunities for US and other Western businesses, along with Soviet Bloc countries, to participate in China's modernization. Shenzhen's fall from grace may bolster the reputations of conservative critics of reform and harm the careers of several second-echelon leaders associated with the SEZs.

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Shenzhen and the Opening to the Outside

By far the largest and most developed of the four Special Economic Zones (SEZ),¹ Shenzhen was once called the 'key to the future' by China's reform leaders. Established in late 1980, Shenzhen was to offer foreigners an improved investment climate through the use of tariff concessions, tax breaks, relatively cheap labor, and simplified administrative procedures for setting up joint ventures. After an initial period of infrastructure development, Shenzhen was expected to attract western high-tech firms with the latest in production facilities for the Chinese to study, and the zone's production was to be keyed to the export market to generate foreign exchange.

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Since its establishment, Shenzhen has been the model for a key element of Deng Xiaoping's policy of 'opening to the outside' -- encouraging local initiative in foreign trade by granting limited trade autonomy to selected areas. Deng has told both national and regional leaders to learn from Shenzhen, and a stream of officials has visited the zone to study its methods of attracting and employing foreign technology and investment. Against the advice of conservative leaders, in early 1984 Deng pushed for establishment of 14 open coastal cities² which were to follow Shenzhen's example.

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An added incentive for the development of the SEZs was the desire to showcase China's ability and willingness to tolerate different economic systems as part of efforts to "reunite" with Hong Kong, Macao, and Taiwan. Shenzhen, Zhuhai, and Xiamen officials have been encouraged to build business ties with investors in Hong Kong, Macao, and Taiwan, respectively.

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¹ Shenzhen, Zhuhai, and Shantou SEZs are located in Guangdong Province. Xiamen SEZ is located in Fujian Province.

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² Shanghai, Guangzhou, Tianjin, Dalian, Zhanjiang, Nantou, Ningbo, Wenzhou, Qinhuangdao, Fuzhou, Lianyungang, Yantai, Beihai, and Qingdao were declared the "14 open coastal cities" in April 1984. Yinkou was added to the list in April 1985, but PRC reports have continued to refer to "14 open coastal cities."

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Second Thoughts on Shenzhen

We believe two key issues led reform leaders to reevaluate their support for Shenzhen early this year: the campaign to control official corruption, and the sharp, unexpected drop in China's foreign exchange reserves. As the leadership focused on these issues, Shenzhen's disappointing economic record and reputation as a center of corrupt activities made the zone a target of high-level criticism. [redacted]

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Deng Xiaoping's comment in late June to an Algerian delegation that Shenzhen was an 'experiment' which he hoped would succeed, but which might fail, was the first public indication that reform leaders had tempered their support for the zone. Although Shenzhen leaders have since claimed that Deng's comment does not represent any change in his position, evidence suggests that Deng had earlier moderated his position on the SEZs in the face of high-level criticism of the 'opening to the outside.' [redacted]

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[redacted] We believe that Deng's comment to the Algerians signaled his intention to stop expending political capital to defend Shenzhen against its critics. State Councillor Gu Mu -- who heads the State Council office in charge of the SEZs -- stated on 15 July that plans to develop the 14 open coastal cities have been scaled back to focus on the four most developed of the cities (Shanghai, Tianjin, Dalian, and Guangzhou). We view this as evidence of a further reorientation in China's trade policy. [redacted]

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Shenzhen's Disappointing Record

Nearly five years after its establishment, Shenzhen has yet to fulfill the expectations of its supporters by becoming an economically viable generator of foreign exchange earnings. Specifically:

- o An unexpectedly large portion of Shenzhen investment has come from inland Chinese sources as provinces and government ministries have sought to get a share of Shenzhen's expertise, foreign exchange, and goods. [redacted] by the end of 1982 foreign investment accounted for about 60 percent of total capital construction investment in the zone. Earlier this year, Premier Zhao Ziyang reportedly indicated that foreign investment is now only 40 percent of the total.
- o The type of foreign investment in Shenzhen has drawn leadership criticism. Between late 1979 and mid-1983, only about 12 percent of investment was in industrial projects; the remainder was almost entirely devoted to real estate development and tourism facilities. The industrial projects which have been established are primarily low technology -- out of 585 industrial projects funded in the first half of 1983, 517 were in textiles and food processing, and only 16 were electronics firms. Shenzhen officials have had to offer concessionary terms to attract the few showcase high-tech firms which do exist in the zone. Roughly 90 percent of foreign investment in Shenzhen has come from Hong Kong sources,

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primarily a spinoff from the real estate boom in the colony in the early 1980s. Few US, Japanese, or West European firms have participated in the zone's development.

- o Shenzhen has not lived up to expectations of producing primarily for export. During a March interview with Hong Kong reporters, Vice Premier Yao Yilin stated that only one-third of SEZ production is actually exported. A Hong Kong press article quoted Gu Mu as stating that since mid-1984 Shenzhen's foreign exchange earnings have been dropping. Other leadership statements imply that the zone has become a net drain on China's foreign exchange reserves. Shenzhen's poor export performance has become a source of acute embarrassment in light of Beijing's discovery early this year of an unexpectedly large drop in foreign exchange reserves.

[redacted]

Corruption in Shenzhen

Shenzhen's disappointing economic results have left its backers with little defense against charges that the zone is a center of corruption. Since late 1984, mounting official corruption in China -- the so-called 'unhealthy practices' -- has become a central political issue. The extent of corruption belies reformist claims that they can control the corrosive aspects of Western society while promoting trade with the West. Although Shenzhen has not been singled out for public rebuke -- perhaps because such charges would embarrass Deng Xiaoping --

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Forms of corruption evident in Shenzhen include black-market currency speculation, unauthorized export of agricultural products to Hong Kong, the widespread practice of officials soliciting bribes to handle nearly all transactions, and smuggling of consumer goods and what the government terms pornographic videotapes and literature into China. Perpetrators include individual entrepreneurs, party cadre, government departments, and provincial trade representatives. Efforts by Shenzhen officials to attract tourists from Hong Kong reportedly have led them to establish casinos, massage parlors, and brothels, all of which contribute to the image of the zone as being rife with decadence and corruption.

[redacted]

What's Ahead For Shenzhen?

As a result of Shenzhen's demotion from 'model' status, the zone will probably be exposed to keener competition from other SEZs, the remaining open cities, and other regions in China for new investments and development credits. The end result may be to force Shenzhen officials to deal more aggressively with problems in the zone, to work harder to acquire high-technology industries, and to push exports.

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According to Hong Kong press reporting, central financial support of the zone is being frozen and may be cut back. Yao Yilin reportedly told Shenzhen officials in late April that the "blood transfusions" of central funds to keep the zone alive couldn't

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continue. During a late June State Council conference on special zones and open cities, Shenzhen was ordered to keep 1985 capital construction investments at last year's level of 1.6 billion yuan, instead of the planned 2.5 billion yuan. Budgets of the other three SEZs were also frozen or cut back. [redacted]

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Several reforms that would have granted Shenzhen greater trade autonomy have been delayed repeatedly, and may now be postponed indefinitely. They include the activation of strengthened border facilities -- including a fence and numerous guard posts --between Shenzhen and Guangdong Province and the issuing of a special currency for the zone. [redacted]

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The "Opening to the Outside" Without Shenzhen

We believe China's policy of 'opening to the outside' will continue, both in propaganda and in fact. China's need for foreign technology and investment is widely recognized, and Chinese leaders understand that the country cannot afford to be seen as a fickle business partner. The SEZs themselves won't be simply abandoned; China will attempt to realize some return on its investment in the zones, and the Xiamen SEZ will probably continue to receive preferential treatment as part of Beijing's efforts to build commercial links with Taiwan. [redacted]

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China's development strategy with regard to foreign technology and investment is likely to shift, however. Chinese leaders now admit that Shanghai and other established industrial areas have been a better long-term economic success than Shenzhen and can probably make better use of new development funds, whether from domestic or overseas sources. As an example of this kind of thinking, a recent economic article by a Peoples' Bank of China official called for ending the emphasis on attracting foreign investment to the southern special economic zones and replacing it with a "northern strategy" which would bring more investment to China's interior and permit greater access to China's domestic market by foreigners. While supporting, and indeed expanding the open door policy, the article criticized the SEZs for leading to unbalanced and narrowly focused foreign investment. [redacted]

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One of the lessons Chinese leaders may draw from Shenzhen is that the decentralization of foreign trade authority leads to unacceptable confusion. The unexpected drop in foreign currency reserves is regarded as one symptom of the lack of central oversight over trade arrangements. Chinese leaders have also complained about unnecessary duplication in imports, competition between imported products and domestically produced goods, and encroachment of undesirable elements of foreign culture, all of which have accompanied open trade between Shenzhen and Hong Kong. Beijing moved to recentralize control over foreign trade this spring, setting restrictions on localities' use of foreign exchange and banning local imports of motor vehicles, videorecorders, and other consumer goods. [redacted]

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In our view, a shift to an 'opening to the outside' strategy which stresses developing China's established bases and inland resources will provide continued opportunities for US and other Western businessmen. Priority projects will include

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revitalization of the transportation network, energy development, natural resource exploitation, and export promotion. Firms doing business in China probably will find renewed involvement of central authorities in project approval and stiff bargaining over financing arrangements. [redacted]

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The new trade strategy may also increase access for the Soviet Union and other Eastern Bloc countries to Chinese trade opportunities. Soviet officials have complained of being frozen out of the SEZs and the 14 open coastal cities, and they probably will welcome a downgrading of the zones. It is widely believed that renovation of existing plants, many of which were originally established by the Soviets in the 1950s, is an area in which Soviet assistance is needed. Under the Economic Cooperation Agreement signed in Moscow on 10 July, the Soviets will help China upgrade 17 plants and may transfer additional technology and capital goods. Chinese leaders may well regard trading with Soviet government bureaus less threatening and troublesome than dealing with the corrupting influence of Western businesses. [redacted]

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The Political Consequences of Shenzhen's Reevaluation

The SEZs' clear identification with Deng Xiaoping and his reformist proteges suggest that a reevaluation of Shenzhen could be seen as a setback for the reform program. Deng has visited Shenzhen several times and has encouraged other Chinese leaders to do so in order to get a glimpse of the future China which reformers envisioned. Deng's withdrawal of public support for Shenzhen has cost the SEZs their most ardent and powerful supporter. Although Shenzhen's problems clearly have caused Deng some political embarrassment, we do not believe that Deng's own leadership will be significantly affected by Shenzhen's decline in stature. [redacted]

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Further political fallout from the downgrading of Shenzhen is not yet evident, but conservatives will almost certainly attempt to gain some political capital from Deng's admission that the SEZs have been a mistake. Among second-echelon leaders, Premier

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Zhao Ziyang has been closely associated with the development of the zones, and he may have continued to encourage deals in the zones which used foreign exchange until signs of the drop in reserves became evident. Zhao was reportedly criticized for economic problems during the National People's Congress session in April, and problems in Shenzhen may have been part of the charges leveled against him. State Councillor Gu Mu is also a prime candidate for criticism over Shenzhen's record. It is possible he will be among those scheduled to "retire" from the Party Secretariat at the party delegates conference in September. [redacted]

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